BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
HOFFMAN ELECTRONICS)
CORPORATION)

Appearances:

For Appellant: James B. Isaacs,
James L. Nolan, and
John McDonough
Attorneys at Law

For Respondent: David M. Hinman
Counsel

OPINION

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Hoffman Electronics Corporation against proposed assessments of additional franchise tax in the amounts

of $30,464, $28,427, $20,326 and $43,380 for the income years 1968, 1969, 1970 and 1971, respectively.

The issue for determination is whether appellant's election to retroactively change its method of accounting for research and experimental expenditures was proper.

Appellant manufactures and markets electronic and related products. Appellant's books and records are maintained on the accrual basis for both financial statement and tax reporting purposes. In 1966 and 1967, appellant incurred research and experimental expenses of $1,121,490 and $733,010, respectively, in connection with the company's MICRO-TACAN project, an air navigation device which ultimately was sold to the federal government. Appellant deducted the total amounts of these expenditures in the income years in which they were incurred in accordance with section 24365 of the Revenue and Taxation Code. However, appellant received no tax benefit for either 1966 or 1967 from expensing these costs since other operating expenses exceeded income in both years.

In its franchise tax return for the income year 1968, appellant reflected a retroactive change in its method of accounting for research and experimental expenditures from current write-off to capitalization and amortization. In making this change, appellant included in unamortized research and experimental expense the amount which would have been unamortized on that date if the new method had been used by the company since its inception. The change made in 1968 was followed in 1969, 1970 and 1971. The amounts deducted in each year were $435,200, $411,604, $343,900 and $663,696, respectively.

Respondent audited appellant's returns for the income years in issue and disallowed the deductions claimed for the amortization of the research and experimental expenditures. The disallowance was based on respondent's conclusion that appellant had originally elected to treat the expenditures as current expenses in 1966 and was now prohibited from changing its method of accounting. Specifically, respondent's disallowance was based on subdivision (c) of section 24365 of the Revenue and Taxation Code which provides, in part, that "the [current expense] method adopted shall be adhered to in computing net income for the income year and for subsequent years unless, with the approval of the Franchise Tax Board, a change to a different method is authorized. "

Section 24365 of the Revenue and Taxation Code, which allows research and experimental expenditures to be deducted currently, provides:

> (a) A bank or corporation may treat research or experimental expenditures which are paid or incurred by it during the income year in connection with its trade or business as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction.
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> (b)(1) A bank or corporation may, without the consent of the Franchise Tax Board, adopt the method provided in subsection (a) for its first income year--
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> > (A) Which begins after December 31, 1960, and ends after the date on which this section is enacted, and
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> > (B) For which expenditures described in subsection (a) are paid or incurred.
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> (2) A bank or corporation may, with the consent of the Franchise Tax Board, adopt at any time the method provided in subsection (a).
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> (c) The method adopted under this section shall apply to all expenditures described in subsection (a). The method adopted shall be adhered to in computing net income for the income year and for all subsequent years unless, with the approval of the Franchise Tax Board, a change to a different method is authorized with respect to part or all of such expenditures.

Section 24366 of the Revenue and Taxation Code, which provides for the amortization of research and experimental expenditures, states:

> (a) At the election of a bank or corporation, made in accordance with regulations prescribed, by the Franchise Tax Board, research or experimental expenditures which are--

(1) Paid or incurred by the bank or corporation in connection with its trade or business;

(2) Not treated as expenses under Section 2436.5; and

(3) Chargeable to capital account but not chargeable to property of a character which is subject to the allowance under Sections 24349 to 24354, inclusive, (relating to allowance for depreciation, etc.) or Section 24831 (relating to allowance for depletion); may be treated as deferred expenses, In computing net income, such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the bank or corporation (beginning with the month in which the bank or corporation first realizes benefits from such expenditures). Such deferred expenses are expenditures properly chargeable to capital account for purposes of Section 24916 (relating to adjustments to basis of property).

(b) The election provided by subsection (a) may be made for any income year beginning after December 31, 1960, but only if made not later than the time prescribed by law for filing the return for such income year (including extensions thereof). The method so elected, and the period selected by the bank or corporation, shall be adhered to in computing net income for the income year for which the election is made and for all subsequent income years unless, with the approval of the Franchise Tax Board, a change to a different method (or to a different period) is authorized with respect to part or all of such expenditures. The election shall not apply to any expenditures paid or incurred during any income year before the income year for which the bank or corporation makes the election.

For purposes of the Personal Income Tax Law, section 17223 of the Revenue and Taxation Code corresponds to sections 24365 and 24366 of the Bank and Corporation Tax Law. All three sections arc substantially identical to section 174 of the Internal Revenue Code of 1954.

Section 174 first appeared in the Internal Revenue Code in 1954. Its purpose was to remove the uncertainty which existed under prior law relative to the deductibility of research and experimental expenditures. Basically, section 174 specifies two methods for treating these expenditures. The expenditures may be treated as expenses and deducted as incurred; or, they may bc deferred and amortized. A taxpayer wishing to deduct his expenditures currently is required to adopt the method in the first year in which he has research or experimental expenditures. Adoption of this method merely requires that a deduction for the expenditures be claimed in the return. With one exception, the use of hindsight is not permitted. Once adopted, the current expense method applies to all research and experimental expenditures for the current year and for all subsequent years unless authorization is obtained from the taxing authority to use a different method. (See generally, Blake, Research and Experimental Costs, 16 N. Y. U. Inst. on Fed; Tax. 831 (1957).) The exception was created by the federal regulations which permitted taxpayers who had adopted the current expense method in returns filed before January 2, 19.58, the date the regulations were filed, to retroactively change to a different method without obtaining consent of the taxing agency. (See Treas. Reg. § 1. 174-3(b)(4).)

It is 'with the exception which allows a retroactive change that we are concerned.

As we have noted, section 174 of the Internal Revenue Code of 1954 provided for the deduction of research and experimental expenditures as current expenses. Alternatively, the statute provided that, at its election "made in accordance with regulations prescribed by the Secretary or his delegate, " a taxpayer could treat such expenses as deferred expenses. After enactment of the law but prior to the issuance of the regulations required by that law, the taxpayer was in a dilemma. Pending issuance of the regulations it did not know what requirements might be imposed in connection with any election to defer expenses. As a matter of fact, a taxpayer could not even

elect to treat these expenses as deferred until the regulations were issued. To resolve this dilemma the Treasury Department issued temporary regulations which held the matter in abeyance by indicating that the taxpayer's inability to make a binding election would be handled by allowing an automatic retroactive change in accounting method, but provided that applications to make that change would not be accepted until the final regulations were issued. As we noted above, regulation 1. 174-3(b)(4), as finally issued, gave the taxpayer an automatic consent to a retroactive change relating to the taxable years which fell between the enactment of section 174 and the effective date of the regulations which were required to be issued under that law.

In 1961, following the federal government's lead, California enacted sections 17223, 24365 and 24366 of the Revenue and Taxation Code, the counterparts to section 174 of the Internal Revenue Code. During the hiatus between enactment of the statutes and promulgation of the regulations required by those statutes, the California taxpayer was faced with the same dilemma that existed earlier at the federal level.

Not unexpectedly, respondent attempted to resolve this problem and give the taxpayer a meaningful election for all years which fell between the enactment of the statutes and promulgation of the regulations by following the federal government's action. Although not issuing a comparable temporary regulation, respondent, in 1964, issued the regulations required by section 17223 of the Personal Income Tax Law covering the requirements relating to an election to treat research and experimental expenditures as deferred items. Included in these regulations was a provision granting the same automatic consent to a retroactive change as had been granted by the Treasury Department in dealing with section 174. (See Cal. Admin. Code, tit. 18, reg. 17223(d) subd. (2)(C).)

Five years after issuing the regulations under section 17223 and over seven years after enactment of the statutes, respondent promulgated the regulations required by sections 24365 and 24366. (Cal. Admin. Code, tit. 18, regs. 24365-24368.) These regulations,

like their federal and state counterparts, contemplated an automatic consent when a taxpayer-made a retroactive change of accounting method from the expense method to a different method. 1/ The regulation required that certain information be submitted to the Franchise Tax Board and required that, if necessary, amended returns be filed for prior years affected by the change. However, the automatic consent regulation contained a fatal flaw. The regulation, which was not filed until January 6, 1969, and was not effective until February 5, 1969, required that, in order to obtain the automatic consent, the taxpayer had to submit certain information on or before January 2, 1969. Thus, the regulation conditioned respondent's automatic consent to the retroactive change on the performance of an act which was literally impossible to perform.

Against this background, appellant argues that its initial treatment of these expenses in the 1966 and 1967 returns was not a binding election, and concludes that its treatment of research and experimental expenditures in 1968 and subsequent

1/ Cal. Admin. Code, tit. 18, reg. 24365-24368(c), subd. (2)(D) specifically provides:

> Special Rules. If the last day prescribed by law for filing a return for any income year (including extensions thereof) to which Section 24365 is applicable falls before January 2, 1969, consent is hereby given for the taxpayer to adopt the expense method or to change from the expense method to a different method. In the case of a change from the expense method to a different method, the taxpayer, on or before January 2, 1969, must submit to the Franchise Tax Board the information required by paragraph (C) of this subsection. For any income year for which the expense method or a different method is adopted pursuant to this paragraph, an amended return reflecting such method shall be filed on or before January 2, 1969, if such return is necessary.
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> History: 1. New section filed l-6-69; effective thirtieth day thereafter (Register 69, No. 2).

years did not constitute a change in accounting method for which pcrmi ssion was required. Alternatively, appellant argues that, if its treatment of the expenditures in 1968 constituted a change in its accounting method for which permission was required, the change was proper since it complied with the intent of the regulations, which were impossible to comply with literally.

We will first examine appellant's contention that its initial treatment of these expenses in 1966 and 1967 was not a binding election so that its treatment of research and experimental expenditures in 1968 and subsequent years did not constitute a change in accounting method for which permission was required.

Although the term "election" is conspicuously absent from section 24365 which speaks in terms of "adopting" the method, the procedure prescribed by the regulations for adoption constitutes an election as that term is commonly understood. (See Cal. Admin. ('ode, tit. 18, reg. 2436524368(c).) Generally speaking, an election may be defined as "the choice of one or two rights or things, to each of which the party choosing has an equal right, but both of which he cannot have. " (Samuel W. Weis, 30 B.T. A. 478, 488.) The principles governing election are equitable, and the considerations which deal with finality or irrevocability are all directed toward fairness and equity. (See, e.g., National Lead Co. v. Commissioner, 336 F. 2d 134, 1.37; see also 10 Mertens, Law of Federal Income Taxation § 60.19, p. 87.)

Initially, we observe that we are not confronted with a taxpayer seeking a double deduction since appellant received no tax benefit from the expenditures claimed as deductions in 1966 and 1967. Mere, we are confronted with a situation where the statutes purported to give the taxpayer the choice of two equally valid alternatives in its treatment of research and experimental expenditures. In accordance with the statutes the taxpayer could choose to expense the expenditures currently, or could defer and amortize them over a period of not less than 60 months. In order to choose the latter method, the specific language of the statute required the taxpayer to elect in accordance with regulations prescribed by the Franchise Tax Board. Thus, until regulations were promulgated, the taxpayer's choice between the two equally

valid alternatives was wholly illusory. Respondent obviously recognized this fact and attempted to implement the statutory intent by issuing regulations which contained the provision authorizing the automatic consent to a retroactive change discussed above. However, as we have noted, the automatic consent provision was defective and impossible to comply with when issued.

Faced with this untenable position, and desirous of exercising the option provided by the statute, appellant's' course of action was not unreasonable. On its 1968 return, appellant indicated its intention to defer its research and experimental expenditures and amortize them over a 60 month period.2/ In effect, it treated its prior action in claiming the expenditures as current expenses in 1966 and 1967 as a non-binding election and elected to defer and amortize the expenditures in accordance with the option presented by the statutes.

At the time appellant filed its returns for 1966 and 1967, for all practical purposes, a viable choice between- two equally appropriate alternatives did not exist. Therefore, under the unique facts presented by this appeal, we conclude that appellant's action in claiming research and experimental expenditures as current expenses in 1966 did not constitute a binding election and that appellant properly elected to defer and amortize these expenditures on its 1968 return. To hold otherwise would require us to conclude that the option offered by the statutes and intended to be implemented by the regulations was an empty promise from the time the statutes were enacted until the regulations were promulgated. We cannot attribute any such intent to either the Legislature or to respondent in its rule-making capacity. In view of this determination it is unnecessary to consider appellant's alternative argument.

2/ Apparently, the 1968 return contained all the information required by the regulations whether we view appellant's action as an initial election or a change of method. (See 'Cal. Admin. Code, tit. 18, regs. 24365-24368(d), subds. (l)(E)(2)(A) and (l)(E)(2)(B) and 24365-24368(c), subd. (2)(C).) The only possible exception would be that if we treat appellant's action as a change in accounting methods appellant did not include amended returns for 1966 and 1967. However, the regulations require amended returns only if necessary. Here, there was no tax change for either 1966 or 1967 since appellant received no tax benefit during those years. Accordingly, amended returns would not have been necessary.

Appeal of Hoffman Electronics Corporation

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Hoffman Electronics Corporation against proposed assessments of additional franchise tax in the amounts of $30,464, $28,427, $20,326 and $43,380 for the income years 1968, 1969, 1970 and 1971, respectively, be and the same is hereby reversed.

Done at Sacramento, California, this 22nd day of June, 1976, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____ Secretary